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This is a multi-part article written to help unravel the myths behind commercial real estate statistics and highlight what is really important to understanding whatever commercial market you are analyzing...

Welcome . . .

CA Commercial Realty Partners has a passion for real estate and we bring that with us to every assignment.

The Company was formed in 2005 by two individuals, Bob Canter and Jake Adler, who have a common belief and mission that they can provide superior commercial real estate services with the client's best interest as their foremost priority. We don't need to brag about our services, our clients do that for us.

Market Statistics: How to Read Commercial Real Estate Market Statistics and What's Really Important?

It is hard to pick up a newspaper or business magazine and not see a section on commercial real estate office market statistics. They are usually filled with graphs, charts and tables and little to no explanation of what those numbers mean. In an ongoing effort to keep people informed, I will be writing a series of articles explaining the indicators most commonly published. Part I of this series focuses on Vacancy rates.

The simple definition of the vacancy rate is the percentage of space in a given area that is unoccupied. Nothing is ever truly simple in the commercial real estate world, so here is where things get a bit tricky. Can a space be vacant and leased at the same time? What constitutes vacant or unoccupied space? What is a healthy vacancy rate? ***How important are*** vacancy rates? Does vacant sublease space matter? Lastly, why is it that no two market reports show the same statistical numbers?

A space can be leased and vacant at the same time. If a tenant signs a lease for space, the space will have to be vacant in order for them to move in. The space may be listed on the market while it is vacant, occupied or under construction. A vacant space means there is no tenant physically occupying it. A tenant may sign a lease for space but not occupy that space for say three to six months while the space is being built and configured to their specifications. The space is not being listed in the active market anymore because it has been leased by a tenant, but will still show up in some market reports as being vacant, since it is not physically being occupied. Usually a tenant will start paying rent when the landlord completes the build-out for the tenant.

A tenant may be paying rent on the space, but due to some circumstance is not occupying it. One reason may be that the tenant signed a lease for the space but then decides against moving to that location. Sometimes a tenant will lease more space than it needs so that it has a large block of space and can grow into it as it expands. Other times, a tenant may be cutting back on staff, thus requiring them to use less space. In these scenarios, a tenant will most likely try subleasing their space. The space is unoccupied and actively on the market as sublease space. However, sometimes a tenant will opt to not market this vacant space as sublease space. One reason may be that they don't want the perception that they are going through hard times. The term "shadow space" is sometimes used to describe this space.

From a landlord's perspective, he or she is being paid rent on that space even though it is not being used. If

it is a high credit tenant, the landlord may not care, as he or she is collecting a monthly rent check. Here it gets tricky again. A landlord may get his or her building 100% leased to a high credit tenant, but the lender they have their mortgage with will still calculate a vacancy allowance in determining their loan amount. The lender may say that they will assume a 5%-10% vacancy in the building, thus hedging their loan in case some vacancy does arise, this way the borrower could still afford their mortgage payments. Most landlords like to see lower vacancy rates, as it means there is less supply of space in the market, meaning they can charge more rent (simple supply VS. demand economics).

From a tenant's perspective, they too do not care about vacant space that has been leased if it is not available for them to lease or sublease. Once space is leased it is gone from the market from a tenant's point-of-view. The space leased is not an option for the tenant anymore, so they don't care if it is occupied yet or not as far as the vacancy rate is concerned. They could however try to sublease the space from that tenant. Tenants like high vacancy rates. It usually means there are more spaces for them to choose from. It also means the rental rates will usually be lower.

A property can be constructed, pre-leased by tenants, and delivered vacant because the tenants have not moved in yet. It has always been a question as to when a building is considered complete and delivered. A building should only be considered delivered when a certificate of occupancy is granted, thus allowing tenants to move into their spaces.

There is one more type of vacant space that should be explained, and those are properties that are uninhabitable. A property can be deemed uninhabitable due to environmental issues (Asbestos in a building) or condemned due to structural damage. Properties in these conditions should not be included in a vacancy analysis, as they do not have a certificate of occupancy.

How Are Vacancy Rates Calculated, What is a Healthy Vacancy Rate and Why Do All Market Reports Quote Different Rates?

Vacancy rates are calculated by taking the vacant space in a market area and dividing that by the total amount of space in inventory. Space in inventory means both leased space and vacant space. For example, if a building is 100,000 square feet and 10,000 square feet is vacant, the building has a 10% vacancy rate. The question though is, what inventory is being used when market reports quote their vacancy rates?

Some companies may include all office buildings regardless of their size or use. Other companies may not include owner-occupied properties or government owned and occupied buildings. Other companies may choose a cut-off based on size, say only properties above 50,000 square feet. Lastly, companies may define their sub-markets differently (i.e. Downtown is a sub-market of the Washington D.C. Market).

That being said, though all these reports quote different rates for the “same” sub-markets, they can all be right; it is just a matter of what criteria they used. In my opinion all buildings regardless of their size or use should be included. Regardless of the market, the government is the largest tenant. If the government leases space from a private owner, that building is included in inventory by all. If the government owns their property and occupies it, most reports will not include those properties in their reports.

What difference does it make if they own their building or lease their building? At any given time the government can decide that the building they own does not meet security standards and move to a different property. All would agree that if that property was sold to a private investor and offered for lease to the general public that it be added to inventory. If all market reports included government owned and occupied buildings, vacancy rates would be lower in ALL markets.

From an economic standpoint, this makes the most sense. Since the government is the largest tenant in all markets, it is also the largest employer in these markets. The government creates and provides the most jobs, so we want to see how the whole market is doing. Government employees earn income, pay ***taxes, spend money,*** travel, and commute, consume and produce products, get laid-off, etc. They are included in demographic reports, which are critical to retailers and housing developers. The buildings they work in are fully functional, have a certificate of occupancy, and thus are critical to the Market.

Lastly, what is a good or healthy vacancy rate? There is no set number that determines a good or bad vacancy rate. A rule of thumb is anything below 10% is a tight market, though that number cannot be totally relied on. It is really all based on your perspective and the Market's history. That is, some buildings are just old and outdated and are not viable for modern tenant's needs. The buildings have certificates of occupancy, but no one will choose to occupy the buildings. They remain vacant and part of the market analysis until they are razed, upgraded, or converted to another use.

A market can have low vacancy, low unemployment, and companies expanding their operations like here in Washington D.C. These factors spur development and construction of new projects. Lenders are happy to provide capital for these projects. Markets with super low vacancy rates, like New York City and San Francisco in the late 1990's offered tenants very few options for space, while landlords there enjoyed high rental rates. When the market collapsed these markets had the most vacant sublease space as companies were leasing more space than they needed because they were hedging their future expansion while the market was so tight. They wanted to hedge their bet for future growth to make sure they had enough space. On the other side of the spectrum, a market can have high vacancy rates of say 20%, low unemployment rates and companies not looking to expand. Lenders in those markets will be hesitant to provide capital for new development and construction, as the market is already over-built.

As for perspective, tenants like higher vacancy rates as it usually means more space choices. Building ***owners like lower*** vacancy rates because they can charge more for rent. The government likes lower vacancy rates because it means the economy is flourishing and also because property values go up when rental incomes increase, thus property tax revenues go up. Lenders like lower vacancy rates because they can issue more loans for new construction with lower risk. Owners of raw land like low vacancy rates as well, since they will have an easier time getting a construction loan from a lender and will also be able to charge higher rents.

The last thing to note about vacancy rates is the size of the space that either the landlord has and is trying to get leased or the space requirement of the tenant looking for space. As a landlord, if he or she has 100,000 square feet of space available in a modern office building, and there are no other spaces of that size in that sub-market, he or she can charge a premium for that space. The tenant's only other options in this case are to either lease more than one location, lease space in a different sub-market, or build-to-suit a property that satisfies their requirement. In this scenario, a high vacancy rate may not impair the landlord. On the other hand, a tenant may be looking for 5,000 square feet, and though the sub-market may have a lower vacancy rate, there may be 100 choices in that size range, thus driving down the price.

Vacancy rates can have an impact on a landlord or sub-landlord looking to lease or sublease space. They can also have an impact on a tenant looking to lease or sublease a new location. Governments, lenders and developers can also be impacted. The vacancy rate is not necessarily an economic indicator (New Jersey has vacancy rates above 18% and low unemployment rates). Therefore, as someone in the general public reading these charts, the numbers do not matter much. Lastly, the numbers that matter to the active parties are: is the vacancy rate higher or lower now than what was previously the case at some point in the past, and going forward, will it go up or down.

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Next Issue... Availability rates, absorption rates, and rental rates)